



NAVAL
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MONTEREY, CALIFORNIA

CONRAD ESSAY

**Leasing Versus Purchasing Lessons Learned from
CINCPACFLT's Lease of Dell Information Technology**

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June 2003**

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Report Documentation Page				Form Approved OMB No. 0704-0188	
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1. REPORT DATE JUN 2003		2. REPORT TYPE N/A		3. DATES COVERED -	
4. TITLE AND SUBTITLE Leasing Versus Purchasing Lessons Learned from CINCPACFLT's Lease of Dell Information Technology				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S) LCDR Christopher J. Koczur				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Naval Postgraduate School, Monterey, CA				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release, distribution unlimited					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT SAR	18. NUMBER OF PAGES 21	19a. NAME OF RESPONSIBLE PERSON
a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified			

BACKGROUND

On June 30, 1999 Fleet Industrial Supply Center Norfolk, Detachment Philadelphia (hereafter referred to as FISC) received a requirement from Commander in Chief, U.S. Pacific Fleet¹ (CINCPACFLT) for the acquisition of information technology (IT) equipment in order to support Year 2000 (Y2K) remediation efforts. Because FISC had previously established Blanket Purchase Agreements (BPAs) with several computer firms during previous IT equipment purchases, CINCPACFLT asked FISC to execute a similar arrangement for their IT acquisitions. CINCPACFLT desired to use FISC's significant experience and knowledge in IT BPA contracts. The timeline between requirements generation and delivery was compressed because CINCPACFLT needed all of the equipment in place throughout the CINCPACFLT area of responsibility (AOR) before 31 December 1999. Additionally, CINCPACFLT informed FISC that they did not have Other Procurement, Navy (OPN) funds available for purchasing IT equipment. However, CINCPACFLT did have sufficient Operations and Maintenance (O&M) funds to lease the needed IT equipment. Within these major constraints, CINCPACFLT and FISC executed three lease contracts: one for ashore-based commands (hereafter called the ashore lease), one for forces afloat commands (hereafter called the afloat lease), and one for eight file servers (hereafter called the file server lease).

Over the three-year lease period, various stakeholders in the three contacts, including CINCPACFLT, Dell, FISC, Naval Supply Systems Command (NAVSUP), and the Office of the Assistant Secretary of the Navy (ASN) questioned some of the business, contracting, acquisition, financial, and legal decisions embodied in the contracts and during contract execution.

In this research project, my team members Wes Spidell and John Buckley,² and I researched some of the issues associated with these leases. This research project

¹ In October of 2002, Secretary of Defense Rumsfeld directed all unified commands to drop the "Commander in Chief" or "CINC" designation from their commands. The new name of CINCPACFLT is now Commander, Pacific Forces (COMPAC). Because all of the actions in this case occur before the title change, we used CINCPACFLT throughout the paper. For further information on the name changes, see <http://usgovinfo.about.com/library/weekly/aacincsunk.htm> accessed May 20, 2003.

² LCDR Wes Spidell, US, an E-2C Naval Flight Officer, is also a Financial Management (837) student. LCDR Juanito Buckley, LCDR, SC, USN, is a Contracting (815) student. The research project was a culmination of all three of our efforts with our advisors' (Professor Jeffrey Cuskey and Professor Jerry McCaffrey) support and guidance.

examines some of the issues, decisions, outcomes, and lessons learned of the three CINCPACFLT- Dell IT lease contracts, both in preparation and execution. It is intended to help educate the defense acquisition and business workforce to better understand the problems and issues associated with this particular acquisition strategy. Our intention is to help future Department of Defense (DoD) acquisition, financial, and business professionals avoid some of the same pitfalls of the involved participants.

Although the research project encompassed a wide variety of both contracting and financial management topics, this paper will focus mainly on the financial management issues and fiscal policies associated with leasing contracting. I will first provide a brief overview of the contracts including using Federal Supply Schedules (FSS) and BPAs. Next, I will discuss three of the primary areas of the research project; leasing versus purchasing decisions, types of leases, and possible “color of money” and Anti-Deficiency Act (ADA) violations that certain types of leases may cause. Finally, I will make recommendations for avoidance or mitigation of future problems.

CONTRACTING

To solve Y2K and IT-21 issues, CINCPACFLT was going to take about \$100 million out of the O&M budget to lease new computers for the fleet.³ The FSS program, which is directed and managed by the General Services Administration (GSA), provides DoD and other federal agencies with a simplified contracting process for obtaining commonly used commercial supplies and services at prices associated with volume buying.⁴ Utilizing the FSS is relatively straightforward. An organization simply reviews the schedule for product availability, follows ordering requirements, and orders the supplies or services.⁵ Organizations find that using GSA schedules is a convenient and quick way to obtain needed supplies and services.

³ FISC Norfolk Det Philadelphia Source Selection Information Sheet (Control number 2002-3933, 3934, 3935).

⁴ FAR, Part 8, accessible on the Defense Acquisition University (DAU) Defense Acquisition Deskbook (DAD) website as <http://deskbook.dau.mil/jsp/default.jsp>, accessed June 1, 2003.

⁵ Ibid.

A BPA is a simplified method of filling anticipated repetitive needs for supplies or services by establishing "charge accounts" with qualified sources of supply. BPAs should be established for use by an organization responsible for providing supplies for its own operations or for other offices, installations, or projects. By using a BPA against an FSS, organizations can often obtain volume discounts and further reduction in published FSS rates. Using BPAs, however, does not exempt an agency from the responsibility for keeping obligations and expenditures within available funds.⁶

CINCPACFLT was aware that Commander in Chief, Atlantic Fleet (CINCLANTFLT) had used a similar acquisition strategy (BPA against an FSS) and therefore made the decision to request that FISC make a similar arrangement for their command. After conducting some market research and performing a brief lease versus purchase analysis, the FISC Primary Contracting Officer (PCO) initiated three contracts for computer equipment. The PCO and CINCPACFLT selected Dell Computers as the company best able to meet the requirements of all three contracts. The first contract was to meet CINCPACFLT's ashore requirements. The second contract was to meet CINCPACFLT's afloat requirements. The final contract was for eight large storage device file servers; all placed in major shore installations in CINCPACFLT's AOR.

Due to the lack of funding mentioned earlier, CINCPACFLT was unable to consider a purchase option. Since CINCPACFLT did not have sufficient OPN funds to purchase the IT equipment, they decided to lease the equipment. Dell offered several different leasing options (discussed further later in this paper). CINCPACFLT and FISC decided to pursue a three-year lease, paid monthly, that was divided into either quarterly or annual option periods. Table (1) below summarizes the BPA and FSS pricing and leasing (total of 36 payments). This table also shows that CINCPACFLT and FISC were able to obtain further price reductions by using a BPA:

Table (1) FSS Pricing and FISC obtained BPA Pricing Information for Dell

Contract Number	Name	BPA Purchase Price (\$)	Monthly Payment (\$)	BPA Lease Price (36 payments)	FSS Purchase Price (\$)	FSS Fair Market Lease (\$)
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⁶ Ibid.

				(\$)		
N00140-99-F-4946	Afloat	34,319,028	916,414	32,990,894	44, 595,248	42,869,768
N00140-99-F-4653	Ashore	72,058,553	2,010,351	72,372,638	89,128,074	89,516,562
N00140-00-F-H026	File Server	4,088,558	109,786	3,952,296	4,894,280	4,731,165

In the fourth quarter of fiscal year (FY) 1999, CINCPACFLT and FISC executed both the afloat and ashore lease contracts. In the first quarter of FY 2000, they executed the file server contract. CINCPACFLT would make periodic lease payments per the contract schedule. At the end of an option period (as long as CINCPACFLT's O&M appropriation was renewed and funds were available), CINCPACFLT would exercise a new option period for each contract.⁷ CINCPACFLT had met their AOR's computer needs for both Y2K and IT-21. However, over the three-year lease, several issues surfaced that led other agencies to question their lease and type of lease decision.

LEASE VERSUS PURCHASE AND TYPE OF LEASE ISSUES

In general, the business decision on whether to purchase or lease any type of equipment (including IT equipment) is affected by many factors. Equipment leasing has some advantages over purchasing. In the corporate world, businesses frequently lease versus purchase equipment. Like the Government, corporations can benefit from:

- (1) Reduced risk of equipment obsolescence
- (2) Included service, maintenance, upgrades, and training
- (3) Obtaining needed equipment when faced with an insufficient capital budget (procurement funds).

Corporations enjoy some other advantages not applicable to the Government. First, the company leasing the equipment gains some significant tax advantages. Operating lease (discussed later) payments are fully tax deductible because corporations

⁷ One of the contracts was on annual option periods. The others were on quarterly option periods for the first two years, and then switched to annual option periods in the third year.

treat them as period expenses. Additionally, by signing an operating lease for a piece of equipment versus borrowing money and buying the assets, the corporation keeps the asset and associated liability off the balance sheet. This concept is known as off-balance sheet financing and can significantly improve debt ratios. For the company that leases the equipment, it can often earn a better rate of return by leasing the equipment than it can by investing the same money in other riskier investments. Unlike other investments, the leasing company can simply take back the piece of equipment if the lessee fails to make payments.⁸

Per the FAR part 7, leasing is an acceptable acquisition method for DoD. Some considerations to make when making a lease versus buy decision include (summarized from FAR 7.401⁹):

- Estimated length of equipment use
- Financial and operating advantages of equipment.
- Purchase price.
- Transportation, installation, maintenance, and service costs
- Equipment obsolescence
- Purchase options.
- Salvage value.
- Availability of service capability (government or outside source can service instead of the manufacturer)

CINCPACFLT and FISC considered several of the lease/purchase criteria listed above when evaluating the Dell leases. With NMCI scheduled to come on line in eighteen months to two years after awarding the contract, CINCPACFLT did not want to

⁸ For further discussions of leasing versus purchase decisions in the corporate world see Eugene F. Brigham and Michael C. Ehrhardt, *Financial Management: Theory and Practice*, Thomson Learning, 2002, Chapter 20.

⁹ FAR, Part 704.1.

purchase the equipment and transfer it to the NMCI contract after such a brief period.¹⁰ With an equipment lease instead of a purchase, all delivery, maintenance, and service were included in the lease price. CONUS areas had next business day service. Even remote areas overseas could get three-day service on repairs. Web-based training was available to Navy IT personnel in routine maintenance and equipment setup. Dell certified the Navy technicians using their web-based training.

CINCPACFLT also used FAR 7.402b criteria to aid their lease versus purchase decision. This section states that leasing may be a preferable method of acquisition when it is appropriate under the specific circumstances.¹¹ The available funding situation influenced the lease decision. CINCPACFLT did not have the necessary OPN funds to purchase the equipment. The only funds they had available to use for the computer procurement were O&M funds obtained as part of the budget cuts recouped from the operational commanders mentioned earlier. O&M money is used for operating expenses generated in the appropriated period for items such as services, supplies, and rental charges for equipment.¹² However, because using O&M money for purchasing items over the investment/expense threshold of \$100,000 violates the “color of money” statute (discussed below), purchasing computer equipment with O&M funds was not a legal option for CINCPACFLT.¹³ When funds are spent that violate the investment/expense threshold or funds are used to purchase items that do not conform to the intention of the appropriation (e.g.- using OPN money to buy office supplies), the expenditure can lead to a “color of money” violation that involves using the wrong type of money to fund a project or an obligation.¹⁴

After deciding to lease the equipment, the next required decision was what type of lease to use. There are two specific types of leases available to a leasing party. The first is

¹⁰ When NMCI is implemented at a command, the NMCI contractor assumes ownership and responsibility of all computer equipment.

¹¹ FAR, Part 7.402b.

¹² Financial Management Regulations (FMR) Vol 2A, CH 1, available on the Internet at <http://www.dod.mil/comptroller/fmr/02a/Chapter01.pdf>, accessed May 6, 2003.

¹³ Mutty, J.E., *Practical Financial Management: A Handbook of Practical Financial Management Topics for the DoD Financial Manager*, Monterey: U.S. Naval Postgraduate School, 2002, p. 21.

¹⁴ Mutty, p. 21.

a capital lease. The Federal Accounting Standards Board (FASB) states that capital leases are treated as the acquisition of assets¹⁵ (much like buying the system outright). A capital lease is basically a “rent to own” arrangement. A leasing contract is classified as a capital lease if the lease meets any of the four criteria listed in Table (2) below¹⁶:

Table (2) Capital Lease Criteria

No.	Capital Lease Criteria
(1)	The lease transfers ownership of the property to the lessee by, or at, the end of the lease term.
(2)	The lease contains an option to purchase the leased property at a bargain price (significantly less than fair market value).
(3)	The lease term is equal to or greater than 75 percent of the estimated economic life of the leased equipment.
(4)	The present value of rental and other minimum lease payments, excluding that portion representing executory costs to be paid by the leasing organization, equals or exceeds 90 percent of the fair value of the leased property

A capital lease essentially transmits all the benefits and risks of ownership of the leased equipment from the lease provider (in this case Dell) to the leasing agent (CINCPACFLT).¹⁷ Because capital leases are essentially “delayed” purchases, they must be funded with OPN funds versus O&M funds if the investment/expense threshold is exceeded.

The second type of lease is the operating lease. It involves paying for equipment or services for a given period of time. The leasing agent does not transfer the title for the equipment to the leasing organization. The lease does not have a bargain purchase price option. In general, if the lease does not meet any of the criteria specified above for a capital lease, then it is treated as an operating lease. With operating leases, none of the benefits or risk of ownership are transferred to the leasing organization from the leasing

¹⁵ FASB Statement #13, Accounting for Leases, available on the Internet at <http://www.fasb.org/st/summary/stsum13.shtml>, accessed May 6, 2003.

¹⁶ FMR, Vol 4, CH 6.

¹⁷ Ibid

agent. Organizations can fund operating leases with O&M funds since this type of lease is not considered a purchase. Because of CINCPACFLT's lack of procurement funds, the only lease option available to them was the operating lease.

The first lease "problem" occurred as soon as the first contract was issued. During an investigation concerning a protest by a competitor of the afloat contract,¹⁸ Naval Supply Systems Command (NAVSUP) and ASN (RDA) discovered that FISC and CINCPACFLT had written the afloat lease as a capital lease, but were paying for it with O&M funds. The lease violated criteria (1) of Table (2) because the terms of the lease had the title transferring to CINCPACFLT after making the last payment. This created a possible "color of money" violation that could have lead to an ADA violation. Because the contract was cancelled and reissued for reasons related to the protest, CINCPACFLT and FISC were able to correct the problem by issuing the contract as an operating versus a capital lease. The other two contracts (file server and ashore) were both originally issued as operating lease contracts. All three contracts were now properly written as operating leases.

During our research, we noted that in June of 1999, the Office of the Inspector General (OIG) issued DoD OIG Audit report 99-195. The report covered leasing contracts awarded in the time period 1995 to 1997. In this report, OIG found that 543 DoD contracts either entirely lacked or did not contain a complete lease versus purchase analysis. Additionally, DoD organizations did not correctly fund eleven contracts that were classified as capital leases (funded capital leases with O&M dollars). These improperly funded leases represented eight million dollars of potential "color of money" and ADA violations, with the Navy responsible for the majority of the eight million dollars.¹⁹ Additionally, organizations sometimes did not perform a lease purchase analysis because they claimed that since they had no procurement funds, they could not purchase the equipment. Therefore, they believed, a lease purchase analysis was not

¹⁸ For specifics of the protest, see the full research project. The protest is unrelated to the issues discussed in this section of the paper. In fact, this protest uncovered the problem early, thus mitigating potential violations.

¹⁹ DoD Office of the Inspector General (OIG), "Contract Actions for Leased Equipment" (DoD OIG report 99-195), June 30, 1999 available on the Internet at <http://www.dodig.osd.mil/audit/reports/fy99/99-195.pdf>, accessed 05 May 5, 2003, p. ii.

applicable. The OIG report noted that organizations that claimed they did not have procurement funds often did not have evidence of attempting to obtain procurement funds before deciding to lease versus purchase the equipment.

After reviewing the lease versus purchase paperwork submitted to FISC by CINCPACFLT, we believe that CINPACFLT conducted a lease versus purchase analysis, but the analysis was incomplete. For example, the analysis did not show the present value of all lease payments versus total purchase price. The lease versus purchase analysis was only done for one of the contracts versus one for each of the contracts. The lease purchase analysis only showed the dollar amounts of individual components versus the total dollar amount of the contract. Although the lease versus purchase analysis addresses insufficient procurement funds for system purchase, it does not address measures that CINCPACFLT took to obtain procurement funding.²⁰ Additionally, it does not appear that the PCO required a written lease versus purchase analysis before awarding all three contracts. The single written lease versus purchase analysis for the ashore contract served as a basis for all three of the contracts. Although CINCPACFLT and FISC may not have been aware of the final audit, the ASN (RDA) issued a letter in April of 1999²¹ addressing such issues as lease versus purchase analysis and types of leases. This letter was issued in support of corrective actions for the preliminary audit.²²

CINCPACFLT and FISC did not take proper steps to ensure compliance with the capital versus operating lease requirements. Had the protest issue never occurred, the incorrect lease may not have been discovered until much later. This could have lead to a potential “color of money” and subsequent ADA violation. We also noted that since the DoD OIG 99-195 audit report,²³ the DFARS has been updated to include the following (updated November 2001):

²⁰ The first section of this report addresses measures taken by the Navy as a whole to obtain sufficient funding for IT requirements.

²¹ Assistant Secretary of the Navy for Research, Development, and Acquisition Memorandum for Distribution, Subject: Equipment Lease or Purchase Under Contract, April 9, 1999. Available on the Internet at <http://www.dodig.osd.mil/audit/reports/fy99/99-195.pdf>, accessed May 5, 2003.

²² Again, we have no way of verifying if this letter ever reached either FISC or CINCPACFLT before executing the lease contracts.

²³ DoD OIG audit report 99-195, p. i.

“207.471 Funding requirements....

(b) DoD leases are either capital leases or operating leases. The difference between the two types of leases is described in FMR 7000.14-R, Volume 4, Chapter 7, Section 070207.

(c) Capital leases are essentially installment purchases of property. Use procurement funds for capital leases.”²⁴

The update added guidance noting that there are two different types of leases and referred readers to the Financial Management Regulations (FMR) for requirements. This change to the DFARS was a corrective action recommended by the audit report.²⁵ Before this change, both CINCPACFLT and FISC would have to know to use the FMR to properly classify leases.

POSSIBLE ANTI-DEFICIENCY ACT (ADA) VIOLATIONS ISSUES

Once CINCPACFLT and FISC had decided to execute an operating lease for the IT equipment versus execute a capital lease or purchase the equipment, they had to decide which of Dell’s GSA schedule terms best fit their operating lease needs and complied with ADA and appropriation regulations. In their GSA schedule,²⁶ Dell offered the following operating lease²⁷ terms:

- (1) Lease with Fair Market Value Purchase Options: This type of lease allows the government to make periodic lease payments over time. At the end of the lease, the government may return the equipment to Dell, purchase the products at the lesser of then current market value or pre-stated purchase option cap (set by Dell and may be given to the government at the beginning of the lease), or renew the lease. The government does not gain any equipment equity by making payments. This type of lease is an operating lease.

²⁴ DFARS 207.471, accessible on the DAU DAD website at <http://deskbook.dau.mil/jsp/default.jsp>, accessed May 13, 2003.

²⁵ DoD OIG audit report 99-195, p. ii.

²⁶ For sample calculations, Dell used a purchase price of \$75,000, a lease period of three years, monthly payments, and interest rates and future value amounts appropriate to the lease. The numbers are not important; but rather how the periodic payments change based on lease type.

²⁷ Dell also offered some capital lease terms. For details, see the full research project.

- (2) Step Lease: This type of lease allows the government to terminate the lease at the end of any fiscal year. The government enters into the lease term for the anticipated length of the lease (from 1-3 years) but can cancel at the end of any fiscal year and return the equipment. Both Dell and the government agree to the future value of the equipment at the end of each year before signing the lease. These calculations and assumptions differ slightly from the other type of leases:

CINCPACFLT and FISC selected the Lease with Fair Market Value Purchase Options. This lease both fulfilled CINCPACFLT's computer needs and fit within their O&M budget. It allowed them to get the maximum benefit from resources expended. We believe that CINCPACFLT never considered the step lease option due to the very high first year payments associated with this type of lease. The final item CINCPACFLT and FISC had to consider was making sure that their operating lease did not commit money that they did not yet have appropriated. Neither organization wanted to commit an Anti Deficiency Act Violation. The Anti-Deficiency Acts are a collective set of laws from U.S Codes (31 USC 1341, 1342, and 1517). ADA violations involve organizations obligating money that they do not have.

As stated earlier, to avoid committing the government to a lease term in advance of an appropriation and to avoid a possible ADA violation, CINCPACFLT and FISC wrote all three contracts as option contracts. Although the contracts were for 36 months, each contract was divided into "options" by quarter or by year depending on the contract.

CINCPACFLT and FISC then executed all three contracts. Just before the beginning of each option period, they would execute the next option with a modification to the original contract. Per FAR 17.207 (exercise of contract options) each modification addressed the following items:²⁸

- (1) CINCPACFLT had a continuing need for the equipment.
- (2) Executing an option was the most advantageous way of fulfilling the need.
- (3) CINCPACFLT needed the equipment on a continuous basis (interruption of service would cause serious problems. This avoids recompeting the contract).
- (4) Funds were available (for options exercised in the same fiscal year) or would be available (for options exercised in a fiscal year for the next fiscal year).

²⁸ FAR, Part 17.207.

For contracts that crossed fiscal year boundaries, FISC followed the guidance of FAR 32.703.2:

“(a) *Fiscal year contracts.* The contracting officer may initiate a contract action properly chargeable to funds of the new fiscal year before these funds are available, provided that the contract includes the clause at 52.232-18 Availability of Funds... This authority may be used only for operation and maintenance and continuing services (*e.g.*, rentals, utilities, and supply items not financed by stock funds) --

(1) necessary for normal operations and

(2) For which Congress previously had consistently appropriated funds, unless specific statutory authority exists permitting applicability to other requirements.”²⁹

FAR 32.703 also requires that FISC cite the following in each option that crosses a fiscal year boundary (FAR 52.232-18):

“Funds are not presently available for this contract. The Government's obligation under this contract is contingent upon the availability of appropriated funds from which payment for contract purposes can be made. No legal liability on the part of the Government for any payment may arise until funds are made available to the Contracting Officer for this contract and until the Contractor receives notice of such availability, to be confirmed in writing by the Contracting Officer”³⁰

Thus, CINCPACFLT and FISC believed they were not committing the government to O&M funding beyond a one-year period. If Congress did not appropriate the funds, then the government was not liable to Dell for continuing the lease.

In March of 2001 (eighteen months after contract execution), the ASN for Financial Management and Comptroller (FM&C) sent a memorandum for distribution to major commands. The memorandum (“Contracting in Advance of an Appropriation”) discussed several issues associated with a type of lease offered by Dell. In this letter, ASN (FM&C) stated that awarding leases using Lease with Fair Market Value Purchase Options (called a “long term order” in the letter) could violate the ADA. The reason for the violation is that these long term orders remove the discretion of the contracting

²⁹ FAR, Part 32.703.2.

³⁰ FAR, Part 52.232-18.

officer. The options are exercised automatically (in our case: provided funds are available) and may even carry a non-renewal penalty for reasons other than non-appropriation of funds. The letter further implies that step leases do not cause the same problems. Since each option is priced separately, each option is considered an individual, annual lease. The letter further requires all commands to review outstanding obligations for this type of problem, cancel or modify contracts that may have this type of problem, and begin an ADA violation report if necessary.

As discussed earlier, CINCPACFLT and FISC wrote all of the contracts as “long order leases.” Although the options did not automatically renew and required PCO involvement to execute an option, the Dell GSA schedule did stipulate that the government could not terminate a lease order to avoid obligations or to obtain similar products or services at better prices. Additionally, the GSA schedule stated that termination was unlikely because of the continuing need.

In late June of 2001, concurrent with exercising the next quarter’s options, CINCPACFLT, FISC, and Dell further modified the contracts to correct the implied problems with the long term leases. Into each contract, the PCO inserted language that released the government from any liability that may result in not exercising an option for any reason. This language was coordinated through all of the concerned parties’ legal staff. According to FISC, this effectively converted the potentially problematic “long order” leases to “step leases” (no penalties or requirements to renew the lease for any reason at the end of the year) with no change in payment structure.³¹ After the changes, CINCPACFLT and FISC were satisfied that the contracts did not violate the ADA. According to FISC, an ADA investigation was started, but to the best of their knowledge was never completed.³²

We agree with ASN (FM&C) that using the Dell GSA schedule’s Lease with Fair Market Value Purchase Options can lead to an ADA violation, if executed for greater than a one-year period. The government cannot use O&M funds (which have only a one-

³¹ Phone conversation between John Buckley, Chris Koczur, and Wes Spidell (NPS project team) and Guy Goss and Dan O’Sullivan (FISC Norfolk Detachment Philadelphia), 5/1/2003.

³² Ibid.

year obligation period) to fund a multi-year Lease with Fair Market Value Purchase Option. Additionally, since it is an operating lease, the government cannot use procurement funds (which have a three-year obligation period) to fund an operating lease.

The only option that the Dell GSA schedule offers that meets both operating lease criteria and fiscal law is the Step Lease. Because step leases do not automatically renew and do not commit the government for a period greater than one fiscal year, they do not violate the ADA acts. Because they are operating leases, the government can fund them with O&M funds. However, step leases significantly increase first year O&M funding requirements versus the Lease with Fair Market Value Purchase Options. Although Dell, FISC, and CINCPACFLT never converted these leases to step leases after the ASN (FM&C) letter discussed earlier, we compute that Step leases cost more.

Although the total sum of the payments in constant dollars over three years is less with a step lease, the step lease uses significantly more O&M funds in the first year over the Lease with Fair Market Value Purchase Options. If the organization is using a lease because of lack of available funding, the step lease does not alleviate the lack of funding problem. The Lease with Fair Market Value Purchase Options also has a lower present value over the three-year stream of payments. In other words, the step lease uses the buying power of the dollars less effectively.

Fiscal law significantly degrades potential leasing benefits to the government. It is difficult for the government to take advantage of long term (greater than-one year) leases. As stated earlier, one of the key advantages to leasing versus purchasing equipment is that it mitigates problems associated with a lack of available funds. If a corporation does not have the necessary financing available to purchase an asset, it can execute a capital or operating lease and obtain the asset. The government, however, must work in two dimensions. If the government has sufficient O&M funds but insufficient procurement funds, it can only execute an operating lease for one year. It cannot take advantage of the long term conditions that multi-year operating leases may offer without the possibility of ADA violations. If it has sufficient procurement funds but no O&M funds, it can purchase or execute a capital lease for the equipment, but cannot enter an operating lease. In some cases, an operating lease may be advantageous such as when the government

only needs the equipment for a short period of time, is concerned about maintenance or service issues, or is worried about technical obsolescence.

Corporate organizations, unlike the government, do not have “color of money” or ADA laws to follow. The only decision the corporation must make once it decides to lease is the terms of the lease, the lease length, and whether to use a capital or operating lease.³³ Corporate organizations would most likely never consider using a “step” type lease option. For corporations, the step lease would add a major disadvantage of purchasing equipment (the high, upfront costs) to an operating lease.

RECOMMENDATIONS

We recommend the following to help minimize future lease versus purchase, capital versus operating lease, and possible ADA problems:

(1) Read OIG report 99-195.

ASN (RDA) should direct all PCOs and agencies considering lease versus purchase acquisition to review DoD OIG report 99-195. This report contains excellent guidance on references, lease versus purchase considerations, and lessons learned. If the organization has a continuing training program, we recommend at least annual training on this report.

(2) Use “checklists” in FAR and DFARS.

PCO’s should prepare a written lease versus purchase analysis, addressing each item of the FAR part 7.4 and DFARS 207.4. Although neither reference has a specific format for addressing each decision point, both references provide the questions that decision makers should ask. If a point is not applicable or important to the analysis, then note it “not applicable.” By using the two references as “checklists,” it will be easier for

³³ Corporations must meet the same four requirements for a capital versus operating lease. FASB standard 13 (available on the Internet at <http://www.fasb.org/st/summary/stsum13.shtml>, accessed May 17, 2003) applies. The purpose of capitalizing the lease in the corporate world is to meet full disclosure requirements. When capitalizing a lease, the corporation records the leased equipment as an asset and the future lease payments as a liability.

both the PCO and the requesting agency to ensure that both organizations meet all the requirements.

(3) Take steps to obtain correct “colored” funds

PCO’s and comptrollers must make an honest effort to obtain procurement funds if purchasing versus leasing the equipment will result in cost savings to the government. As addressed earlier, a lack of procurement funding is not a complete answer when addressing the lease versus purchase decision. When preparing the lease versus purchase analysis, organizations should document all steps taken to obtain procurement funds. This documentation should include a timeline with fund request dates, dates funds needed, and copies of all correspondence with budget authorities.

(4) Standardize the lease purchase analysis.

ASN (FM&C and RDA) should consider standardizing a lease purchase analysis. This would consist of essentially a “fill in the blanks” document. By doing it the same for all organizations, PCOs can quickly identify potential problems before lease versus purchase decisions waste money or violate the law. These standard forms could also help organizations explain why certain decisions were made after personnel transfer or retire.

(5) Document the type of lease.

PCOs and comptrollers should show, in writing, how the lease is a capital or operating lease. The analysis should address all of the criteria contained in FMR 7000.14-R, Volume 4, Chapter 7, Section 070207.

(6) Distribute FISC’s training brief.

After the initial capital versus operating lease problems of the afloat contract, FISC prepared an excellent training brief that addressed this issue. FISC should make this product available to ASN (RDA) and (FM&C) for further distribution via their respective command websites. This brief provides an excellent overview of operating versus capital lease requirements, restrictions on using O&M money for capital leases, and relevant

factors for lease versus purchase decisions. We feel this is an outstanding product for any organization that makes these types of decisions.

(7) Review GSA schedules with leasing options.

ASN (FM&C) should request GSA review all schedules (not just computers) that contain leasing options. GSA should work with the contractor to specifically classify each lease option as either a capital or an operating lease. This may help reduce potential “color of money” violations.

(8) Remove the Lease with Fair Market Value Purchase Options from the Dell GSA schedule.

ASN (FM&C) and (RDA) should request GSA remove the Lease with Fair Market Value Purchase Options from the Dell GSA contract. Although it can be an attractive option from a resources standpoint, we feel that it is impossible to execute this option as written for greater than one year and avoid violating both the “color of money and ADA statutes. If organizations fund this lease with O&M dollars, they can commit ADA violations for committing the government to a contract before Congress makes funding available. If the government uses procurement funds, it can lead to a “color of money violation,” since agencies must fund operating leases with O&M and not procurement funds. In conjunction with the review in above recommendation, GSA should screen other GSA contractor schedules for similar problems

(9) Incorporate ASN (FM&C) letter into continuing training programs.

ASN (RDA) should direct all PCOs and agencies that use or may use leasing as an acquisition method to review the ASN (FM&C) letter. It provides excellent guidance on potential ADA violations when using multi-year leasing agreements. Such organizations should incorporate this letter into their continuing training plans.

(10) Consider generating new lease options.

GSA should consider making the language that effectively changed the Lease with Fair Market Value Purchase Options into a Step Lease with no change in payment structure a permanent addition to the GSA contract. This agreement allowed the

advantages of a long-term operating lease while not contractually obligating the government to a period longer than one fiscal year.³⁴

(11) Establish multi-year O&M funding.

ASN (FM&C) should request DoD Comptroller to seek changes to statute law to allow certain multi-year uses of O&M dollars. If Congress can appropriate O&M in a multi-year format similar to OPN, then government agencies can take advantage of some of the attractive multi-year operating lease features while avoiding the large first year payments associated with step leases.

³⁴ The authors understand that from Dell's point of view, Dell had almost nothing to lose by adding the new language into the contract. By the time the new language was effective, there were only five quarters (one of which the government was effectively committed to exercise) remaining on the lease payments. It made sense for Dell to cooperate with the government to improve their position in future contracts. Had CINCPACFLT attempted a similar move early in the contract (first year) we feel Dell may not have been as accommodating.

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